Charles Schwab Investment Management Perspectives™

Ultra-Short Bond Funds
9.30.06 – 3rd Quarter Review

Analysis and opinions from the Investment Adviser of Schwab Funds® and CSIM Managed Accounts

Ultra-Short Bond Funds — A Longer-Term Cash Alternative

Ultra-short bond funds are an alternative approach to holding long-term cash in a money market fund for those investors with a holding period of at least a year and who can tolerate minimal price fluctuations. Historically, these funds had strong performance in both increasing and decreasing interest rate environments.

When is it appropriate to use an ultra-short bond fund as a cash alternative?

It is possible for the manager of a client portfolio to choose to hold relatively high levels of cash in that portfolio for a variety of reasons. If the manager is creating a high level asset allocation mix for a client, the manager typically chooses from the three primary asset classes of stocks, bonds, or cash. Stocks are typically used for higher total return potential through growth and capital gains, bonds are typically used for higher income and for defensive diversification, and cash is used both for transactional purposes (including spending) and as a way of preserving principal against losses, especially when stocks or bonds are believed to be unattractive. In some cases the low risk tolerance of a particular client may severely limit the proportion of the portfolio that can be put at risk in the stock or bond markets leaving little latitude to the manager. In other cases the manager may have a view of the markets that compels the manager to reduce exposure to the long-term asset categories of stocks and bonds because they are unattractive, possibly even for extended periods of time.

In making these allocations the manager typically first uses a money market fund for cash because of their well known attributes of convenience, liquidity, safety and usually a reasonable yield. Money market funds have numerous legal restrictions on them in order to produce that useful and reliable, but not guaranteed, dollar in, dollar out stability of principal that is often taken for granted. While this high level of stability in a money market fund is very useful, the opportunity cost of having too much of a portfolio in them can be noticeable. In general, when a portfolio has had more allocated to money funds than necessary for basic liquidity and transactional purposes for periods of one year or longer then it has lost the opportunity to achieve higher total return on those amounts in a vehicle with a little less stability of principal such as an ultra-short bond fund. Ultra-short bond funds are not money market funds and their per share net asset values (NAVs) do fluctuate, but they have historically, over periods of one year or longer, offered the possibility of higher total returns with modest risk to principal. For this reason it is advisable to consider using an ultra-short bond fund as an alternative to cash when the expected holding period is one year or longer.

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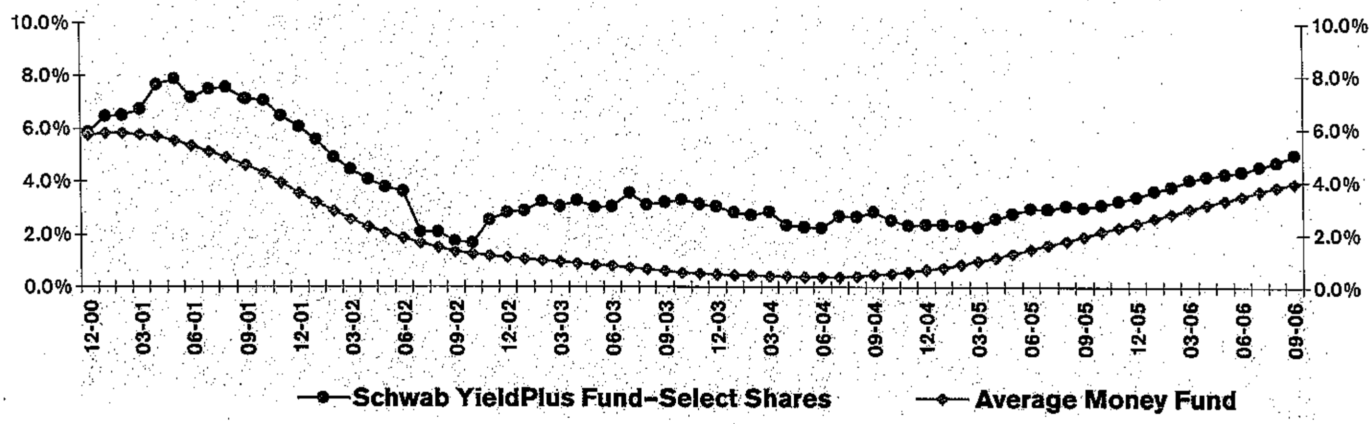
How well do ultra-short bond funds perform?

Because ultra-short bond funds have fluctuating NAVs it is entirely possible that for shorter-term holding periods of say a month or a quarter they may experience a decline in share price and under-perform the total return of a money market fund. However, when given a longer holding period such as a year or more in order for their advantages to work, the historical record shows that an ultra-short bond fund will typically out-perform a money market fund in total return, but this is of course not guaranteed. Below is a chart of the total return of the Schwab YieldPlus Fund®—Select Shares® in rolling twelve month periods compared with the average returns for the iMoneyNet First Tier Retail Money Market Funds category.

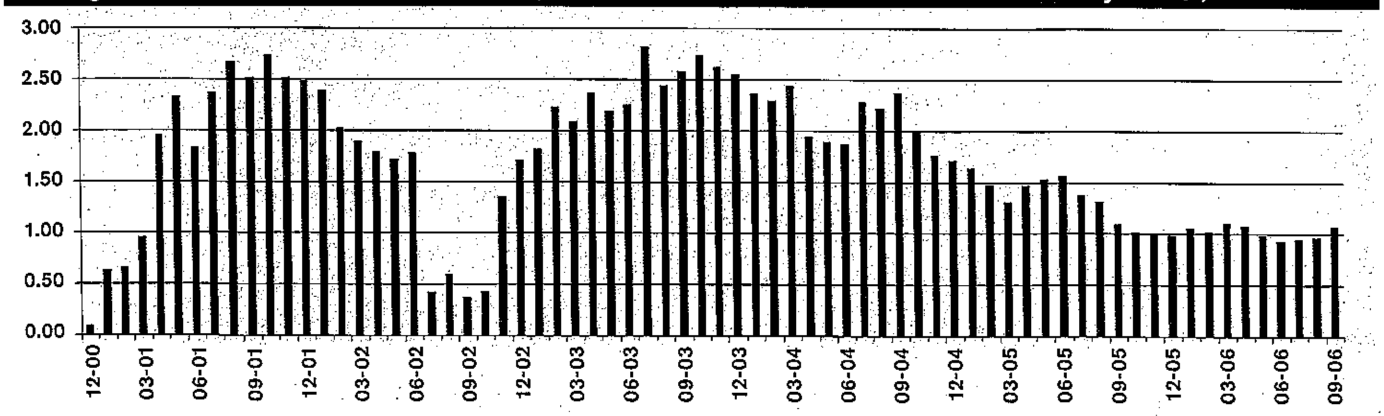
Rolling Twelve Month Total Return Comparison



Past performance is no guarantee of future results. Money Market performance is represented by the average of the iMoneyNet First Tier Retail Money Market Funds category.

The following chart illustrates the difference in total return, measured in percentage points, between the Schwab YieldPlus Fund—Select Shares and the average returns for the iMoneyNet First Tier Retail Money Market Funds category rolling every 12 months. Clearly, an actively managed ultra-short bond strategy has the potential to outperform the total return of a money fund over longer holding periods but without the same stability over shorter holding periods.

Rolling Twelve Month Total Return Difference (Schwab YieldPlus Fund–Select Shares Less Money Market)



Past performance is no guarantee of future results.

This table shows the historical performance of the largest ultra-short bond funds in comparison with the Lipper and Morningstar Ultra-short Bond universe.

Historical Performance of Ultra-Short Bond Funds

Top 10 USB Funds by AUM[1]	1 Year	3 Year	5 Year	10 Year	Since Inception
	Average Annual Total Returns (as of 9/30/06)				
Schwab YieldPlus Fund–Select Shares (SWYSX)[2]	**5.02%**	**3.61%**	**3.14%**		**4.16% (10/01/99)**
Fidelity Ultra-Short Bond Fund (FUSFX)	4.55%	2.80%			2.62% (8/29/02)
Goldman Ultra-Short Duration Instl (GSARX)	4.43%	2.83%	2.86%	4.38%	
Evergreen Ultra Short Opportunities (EUBIX)	4.36%	3.43%			3.67% (5/29/03)
JP Morgan Ultra Short Term Select (HLGFX)	4.28%	2.87%	3.12%	4.68%	
AMF Adjustable Rate Mortgage (ASARX)	4.27%	2.61%	2.61%	4.30%	
Gartmore Enhanced Income (NMEIX)	4.22%	2.30%	2.15%		2.75% (12/29/99)
Wells Fargo Ultra Short-Term Income Inv (STADX)	4.19%	2.96%	2.49%	4.12%	
Dimensional Fund Advisors 1-Year Fixed (DFIHX)	4.19%	2.29%	2.60%	4.25%	
PIMCO Short-Term Inst (PTSHX)	4.08%	2.68%	2.79%	4.57%	
Lipper Ultrashort Bond Category Average	4.10%	2.49%	2.36%	4.15%	
Morningstar Ultra-Short Bond Category Average	4.08%	2.41%	2.40%	4.12%	

Investment values will fluctuate so that shares, when redeemed, may be worth more or less than their original value. The performance data quoted represents past performance and is no guarantee of future results. Current performance may be lower or higher than the performance data quoted. Visit www.schwabfunds.com for month-end performance information.

Source: Lipper (except for Morningstar Category Average, which is provided by Morningstar). Lipper and Morningstar Inc. are independent third parties that provide rankings, research and other information about the mutual fund industry.

[1] Excludes funds with less than 3 years of performance history.

[2] Select shares are available for initial purchases, or aggregate positions, of $50,000 or more.

This next chart shows the top 10 ultra-short bond funds by AUM and how each USB fund including the Schwab YieldPlus Fund–Select Shares compared with each other in the period since the Federal Reserve began its latest campaign of federal funds target rate increases. As you can see below, the ultra-short bond fund strategy provided positive and competitive total returns even in a period of rising short-term interest rates, but the level of returns and volatility vary.

What has Been the Impact Since the Fed Began Raising Rates?

Top 10 USB Funds by AUM[3]	6/30/04–9/30/06 Total Return	6/30/04–9/30/06 Price Volatility[4]
Schwab YieldPlus Fund–Select Shares (SWYSX)	**3.95%**	**0.62%**
Evergreen Ultra Short Opportunities Fund (EUBIX)	3.91%	3.04%
Wells Fargo Ultra Short-Term Income Inv (STADX)	3.52%	1.64%
JP Morgan Ultra Short Term Select (HLGFX)	3.36%	2.45%
Goldman Ultra-Short Duration Instl (GSARX)	3.20%	1.29%
Fidelity Ultra-Short Bond Fund (FUSFX)	3.17%	0.50%
PIMCO Short-Term Inst (PTSHX)	3.15%	1.20%
AMF Ultra Short Mortgage (ASARX)	3.02%	2.05%
Gartmore Enhanced Income (NMEIX)	2.97%	1.10%
Dimensional Fund Advisors 1-Year Fixed (DFIHX)	2.96%	1.67%

Investment values will fluctuate so that shares, when redeemed, may be worth more or less than their original value.The performance data quoted represents past performance and is no guarantee of future results. Current performance may be lower or higher than the performance data quoted. Visit www.schwabfunds.com for month-end performance information.

[3] Excludes funds with less than 3 years of performance history.

[4] Volatility is measured as maximum percentage change in NAV year-to-date. [((High NAV – Low NAV) / Avg. NAV) x 100]. Volatility can change over time and current measures of volatility do not necessarily reflect future results.

Source: Bloomberg L.P.

This next table shows performance versus volatility of return.

Performance, Volatility and Excess Return (Alpha), (October 1, 2003 – September 30, 2006)

Top 10 USB Funds by AUM[5]	Annualized Total Return	Excess Return vs. Benchmark	Information Ratio vs. Benchmark	Sharpe Ratio	Alpha vs. Benchmark	Beta vs. Benchmark	Standard Deviation
Schwab YieldPlus Fund®–Select Shares®	**3.61%**	**1.30%**	**2.93**	**2.24**	**2.47%**	**0.49**	**0.43%**
Evergreen Ultra Short Opportunities Fund	3.43%	1.11%	1.96	0.93	0.91%	1.08	0.84%
Wells Fargo Ultra Short-Term Income Inv	2.96%	0.65%	1.24	0.54	1.55%	0.60	0.58%
JP Morgan Ultra-Short Term Select	2.87%	0.55%	1.41	0.30	0.41%	1.06	0.73%
Goldman Ultra-Short Duration Instl	2.83%	0.51%	0.89	0.35	1.83%	0.43	0.53%
Fidelity Ultra-Short Bond	2.80%	0.48%	1.71	0.30	1.03%	0.76	0.50%
PIMCO Short-Term Instl	2.68%	0.36%	1.20	0.06	0.82%	0.80	0.54%
AMF Adjustable Rate Mortgage	2.61%	0.30%	0.94	-0.06	0.70%	0.82	0.56%
Gartmore Enhanced Income	2.30%	-0.02%	-0.07	-0.57	0.13%	0.94	0.61%
Dimensional Fund Advisors 1-Year Fixed	2.29%	-0.03%	-0.10	-0.48	-0.43%	1.17	0.74%
Lehman Treasury Short (9–12 mos.) Index	2.32%	0.00%	0.00	-0.56	0.00%	1.00	0.58%

Source: Zephyr StyleADVISOR.

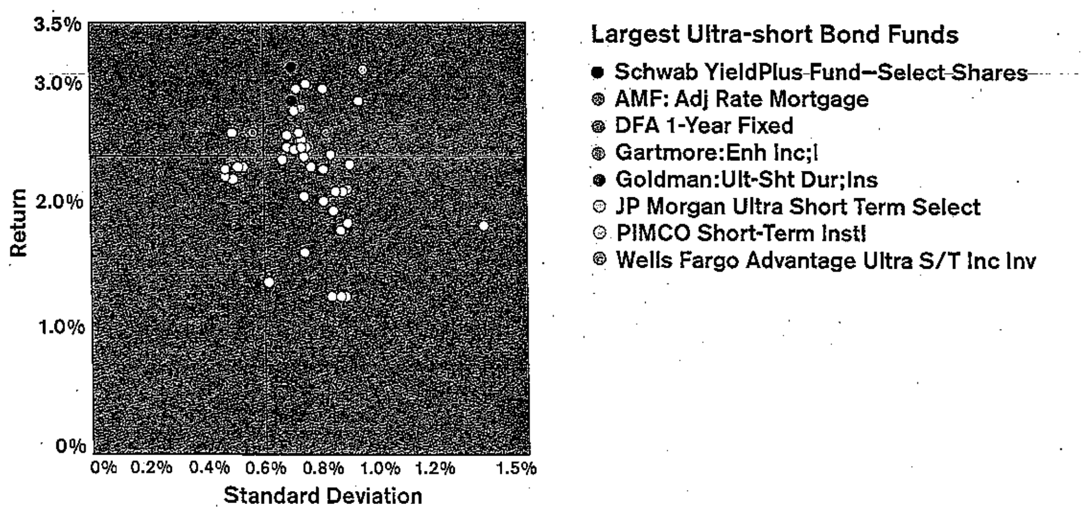
The performance data quoted represents past performance and is no guarantee of future results. Current performance may be lower or higher. The investment return and net asset value will fluctuate so that an investor's shares, when redeemed, may be worth more or less that the original cost. To obtain performance information current to the most recent month end, visit www.schwabfunds.com.

[5] Excludes funds with less than 3 years of performance history.

The table above shows the top ten ultra-short bond funds by AUM and how they compared in terms of their individual annualized total returns, excess returns versus benchmark and alpha versus the benchmark, including their Information ratio, Sharpe ratio and standard deviation. As a category these funds have demonstrated high risk-adjusted performance as measured by the Sharpe ratios, historically showing relatively little volatility when earning these excess returns.

A manager style performance chart graphically shows the recent return and volatility performance of the largest ultra-short bond funds against the Lipper category.

Annualized Return vs. Volatility of Return — 5 Year Risk vs. Return (as of 9/30/06)



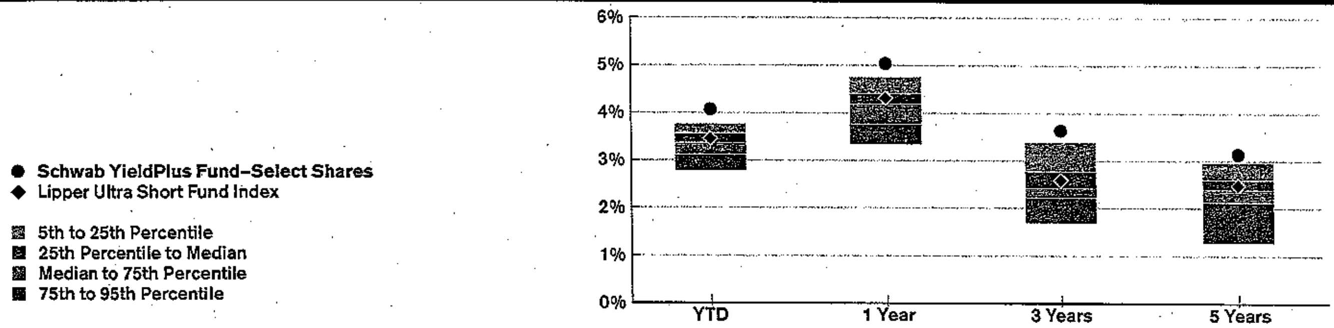
The standard deviation of the return series is the square root of the variance. Standard deviation of return measures the average deviations of a return series from its mean, and is often used as a measure of risk. A large standard deviation implies that there have been large swings in the return series of the manager. The white dots represent other ultrashort bond funds that are not one of the 10 largest ultrashort bond funds. The performance data quoted represents past performance and is no guarantee of future results. Current performance may be lower or higher. The investment return and net asset value will fluctuate so that an investor's shares, when redeemed, may be worth more or less that the original cost. Source: Zephyr StyleADVISOR. To obtain performance information current to the most recent month end, visit www.schwabfunds.com.

The graph's vertical axis represents annualized returns, and the bottom (horizontal) axis represents risk or standard deviation. Ideally, you want a USB fund in the northwest quadrant with a low standard deviation (volatility) and the highest annualized returns. Overall, the historical performance record of ultra-short bond funds has shown the potential to out-perform money funds over one year or longer holding periods as a cash alternative.

Floating bar charts and an accompanying performance table are both commonly used to measure a fund's relative performance to its peer group and a specific index over several different time periods. An added benefit of using these tools is the ability to segment relative returns into quartile rankings among the number of peer group funds competing in each time period measured.

The chart below illustrates how the Schwab YieldPlus Fund—Select Shares has performed relative to the Lipper Ultrashort Fund Index and the corresponding competitors in the Lipper Ultra Short Funds Objective. In each of the four periods measured, Schwab YieldPlus Fund—Select Shares handedly outperformed the Lipper benchmark and placed in the fifth-percentile versus competitors included in the Lipper objective.

Schwab YieldPlus Fund—Select Shares vs. Lipper Ultra Short Bond Universe (as of 9/30/06)



Time Period (Number of Funds)	YTD (80 Funds)	1 Year (80 Funds)	3 Years (65 Funds)	5 Years (41 Funds)
5th Percentile	3.77%	4.76%	3.39%	2.97%
25th Percentile	3.56%	4.40%	2.77%	2.60%
Median	3.37%	4.19%	2.42%	2.40%
75th Percentile	3.12%	3.77%	2.22%	2.13%
95th Percentile	2.79%	3.32%	1.69%	1.39%
Schwab YieldPlus Fund–Select Shares	4.09%	5.02%	3.61%	3.14%
Lipper Ultra Short Fund Index	3.46%	4.31%	2.57%	2.48%

Source: Zephyr StyleADVISOR

Numbers assume reinvestment of dividends and capital gains over each time period. Lipper, Inc. rankings are based on average annual total returns not including sales charges for the periods indicated. Lipper, a wholly owned subsidiary of Reuters, is an independent ranking organization for the mutual fund industry.

The performance data quoted represents past performance and is no guarantee of future results. Current performance may be lower or higher. The investment return and net asset value will fluctuate so that an investor's shares, when redeemed, may be worth more or less that the original cost. To obtain performance information current to the most recent month end, visit www.schwabfunds.com.

What are the sources of ultra-short bond fund performance?

Ultra-short bond funds are called "ultra-short" because they maintain their portfolio average durations shorter than one year, a duration that is substantially shorter than more traditional bond funds that may have durations of three years, seven years or even longer. The strategy was designed to provide an alternative to cash with better total return and low interest rate risk. Because ultra-short bond funds are not money market funds and because they do have fluctuating NAVs they are free to use many investments that are just outside the approved limits of money funds, particularly with respect to duration and quality.

It might seem that simply, almost passively, buying very short maturity corporate bonds in a ladder and letting them mature would be the way to realize the potential for total returns in the ultra-short category but often, the best performing funds do substantially more to earn their returns. Of course, not all portfolio managers achieve this objective. But potentially, using an active approach that involves some combination of the following factors could be successful:

What are the sources of ultra-short bond fund performance? (continued)

- **Risk Control:** Two major risks that active ultra-short managers have to guard against are duration overexposure and credit quality deterioration. Having the appropriate risk controls in place combined with a deep credit analysis team will guard against credit surprises. A good ultra-short manager will keep the duration of their fund just above that of a money market fund at an average effective term of between 180 days and one year, especially in an economic environment when credit liquidity is being tightened through Fed policy. The short-duration of an ultra-short fund allows for high turnover which opens opportunities to purchase higher yielding credit that will mature relatively quick and the ability to take advantage of inefficiencies in the market on the short end of the curve.

- **Portfolio Diversification:** To avoid the affect of negative credit events on performance (such as WorldCom or Enron) or sector rotation, diversification has proven to be an incredibly effective tool. Through diversification, managers can limit the portfolio's exposure to specific issuers as well as over extending a portfolio's exposure to just a few industries and sectors. Generally speaking, the top 20 holdings of the fund should not represent more than 20% of total portfolio assets. In conjunction, the portfolio should be allocated tactically across several industry sectors and differing fixed income classes.

- **Portfolio Structuring:** As risks are diligently managed, investment opportunities are discovered, and market inefficiencies are maximized, active managers must balance appropriate portfolio structuring with generating returns for shareholders. The most important decision an investment manager can make in generating alpha is portfolio allocation and structuring.

The advantages to a skilful active manager of using these different approaches to add value often come from brief and capricious inefficiencies. A manager's ability to unearth inefficiencies in the bond market provides opportunities for a portfolio to generate greater returns and higher alpha that exceed those of passive strategies. Diligent active managers with extensive resources and expertise across key sectors can identify many small and diverse sources of market mis-valuations, which can potentially boost returns on a consistent basis without altering risk levels.

Event risk

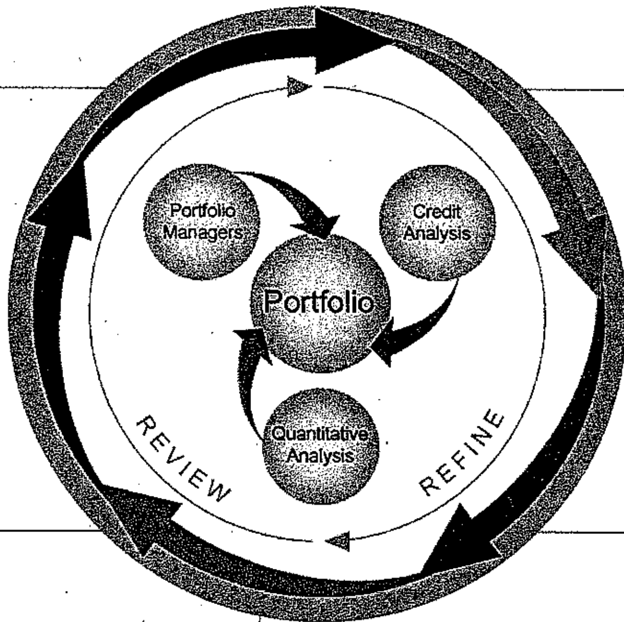
An ultra-short active strategy can also manage for event risk. Two primary event levels can have a significant effect on bond performance. Events on a micro-level are firm-specific; that is, the particular firm that makes decisions that are shareholder friendly, rather than bondholder friendly.

Macro-level events are economy-wide or industry-specific, often making it more difficult to protect yourself from them. In recent years there has been a confluence of developments both domestic and international that have moved the prices of Treasury securities. One such event was the September 11, 2001 attacks, which resulted in adding a geopolitical premium to the US Treasury market, making this market even more of a safe haven. Foreign central bank purchases, particularly from China, and most recently, the increase in the price of oil, have also held down yields on Treasury securities. Though macro-events are hard to predict, one can manage both the size and duration of exposure to the sectors that are potentially vulnerable to these events. For instance, if a marked increase in mortgage rates occurred, it could have a profound impact on the homebuilding industry. If one has a fairly short-duration position with less vulnerable homebuilders, one can manage their risk while not shying away from the sector altogether.

Some event levels fall between micro- and macro-events, surfacing when firms in certain industries such as insurance come under investigation. These events may also seem to happen out of the blue, especially when the first firm in the industry comes under fire. Yet once the initial firm and its vulnerability are identified, one can prepare for similar instances in the future.

The Schwab five-step investment management process

The following diagram illustrates our five-step approach to actively managing Schwab's ultra-short bond funds. Schwab's bond team uses a top-down approach for duration, volatility, yield curve and sector decisions, and bottom-up analysis for individual credit security selection.



Step 1: Duration/Yield Curve Allocation—The management team starts by establishing a fundamental economic outlook and performing quantitative analysis on the management of yield curve risk. We make a forecast of where we think interest rates are going to be. We look at the economic factors that are driving where interest rates are headed, then position the appropriate yield curve risk.

Step 2: Sector Allocation—In collaboration with the credit research team, our portfolio managers establish a fundamental sector outlook, taking into consideration economic trends, interest rate outlook, mortgage prepayment trends, credit and equity markets outlook and sector supply and demand factors, with a foreseeable time frame of 6 to 12 months.

Why credit quality is vital

A key area where a management team can demonstrate a competitive advantage is in credit analysis: everyone has sectors they like and dislike, but having the ability to talk directly to a credit specialist before making a decision can make the difference between average and above average returns. This type of decision-making gives the manager the ability to change strategies if necessary and provides that manager with an extra set of eyes to manage the credit quality exposure of their portfolios.

Step 3: Security Selection—Our security selection process involves a study of economic indicators, credit risk metrics, monetary/fiscal conditions, and industry and company analysis. The credit research team consists of 14 analysts who have investment grade corporate, mortgage/asset-backed and high-yield expertise. The team has strong expertise across all sectors and provides daily surveillance of holdings in corporate, asset-backed and non-agency mortgages, applying our proprietary credit rating system with a strong emphasis on diversification. We evaluate these factors in light of our credit investment philosophy, with an emphasis on asset coverage, cash flow and liquidity. The portfolio's credit risk dovetails with our investment team's view of where we are in the credit cycle.

Step 4: Portfolio Construction—Similar to other management teams, we monitor portfolio risk factors on a daily basis. However, we add another layer of risk management by conducting the following portfolio risk analysis scenarios: 1) What if, 2) Stress tests and 3) Dynamic spread models. The team manager then makes appropriate adjustments to the portfolio.

Step 5: Performance Attribution Analysis—The quantitative team dissects each component of returns in order to assess, refine and enhance the effectiveness of the investment process.

This approach allows for controlled alpha generating strategies which has the potential to maximize realized yield within a structured risk management framework.

Conclusion

Ultra-short bond funds have historically provided total returns above money market funds when held for periods of one year or longer. While there is no guarantee that they will continue to do so there is the clear potential to improve the returns on long-term cash balances in excess of transactional needs by using ultra-short bond funds as a cash alternative with a modest increase in risk.

When selecting a fund in the ultra-short bond fund category it is important to understand the sources of the excess returns being generated and the process by which the manager has created it. The Schwab YieldPlus Fund is the largest fund in the ultra-short bond category with a proven management team. The record of performance and leadership in this category of the Schwab YieldPlus Fund—Select Shares and other funds make ultra-short bond funds worth considering as a longer-term cash alternative.

CSIM Taxable Fixed Income Strategies Management Team

Kim Daifotis, CFA
Senior Vice President and Chief Investment Officer of Fixed Income of CSIM
Mr. Daifotis oversees all aspects of managing the taxable bond, tax-free bond and money market fund portfolios. Kim has more than 20 years of institutional fixed income experience. Prior to joining CSIM in 1997, he held positions in sales and was a senior portfolio strategist at Lehman Brothers, a senior portfolio manager at Barclays Global Investors and an economist for the Chicago Board of Trade. Kim earned his MBA, with an emphasis in Finance, from the University of Chicago and a BA in Economics, specializing in quantitative methods, from Claremont McKenna College. Kim is a Chartered Financial Analyst.

Matthew Hastings, CFA
Vice President & Senior Portfolio Manager of Taxable Bond Funds of CSIM
Mr. Hastings has day-to-day responsibility for the management of the taxable bond funds. Prior to joining Charles Schwab in 1999, Matt was with Lehman Brothers in Fixed Income sales and trading. He has worked in fixed-income and asset management since 1996. Mathew graduated with a BA in Economics from the University of San Diego. Matt is a member of the Association for Investment Management and Research and the Security Analysts of San Francisco. Matt is a Chartered Financial Analyst.

Steven Hung
Director & Portfolio Manager of Taxable Bond Funds of CSIM
Mr. Hung has day-to-day responsibility for the management of the taxable bond funds. Steven joined the taxable bond portfolio management team in May of 1999. Prior to joining the portfolio management team, Steven was an associate in Schwab's management training program. In that role, he worked as a clerk on the options trading floor of the Pacific Coast Stock Exchange. Steven received a BA in Applied Economics from the University of San Francisco and is currently a Level II Candidate in the Chartered Financial Analyst Program. He is also a member of the CFA Institute and the San Francisco Society of Security Analysts.

Andrew Tikofsky, PhD
Director and Portfolio Manager of Taxable Bond Funds of CSIM
Mr. Tikofsky has day-to-day responsibility for the management of the taxable bond funds. Andrew has worked in fixed income and asset management since 1997. Prior to joining CSIM in 2006, he was with the Ellington Management Group, where he managed a portfolio specializing in relative value trading among corporate credit derivatives, bonds and equities. His experience in the asset management industry also includes managing and developing derivative trading strategies at Paloma Partners, JMG Capital and Deephaven Capital. He received his PhD in theoretical physics from Stanford University in 1994, his MS in theoretical physics from U.C. Berkeley in 1990 and his BS in physics and applied mathematics from Caltech in 1987.

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iMoneyNet First Tier Retail Money Market Funds category is the average of the retail tier 1 money market funds with rolling total returns every 12 months.
Lehman Brothers U.S. Short Treasury: 9–12 Months which includes aged U.S. Treasury bills, notes and bonds with a remaining maturity from 9 up to (but not including) 12 months. It excludes zero coupon strips. Index figures do not include trading and management costs, which would lower performance. Indices are unmanaged, and you cannot invest in them directly.

Investors should consider carefully information contained in the prospectus, including investment objectives, risks, charges and expenses. Please read the prospectus carefully before investing.

Investment value will fluctuate, and shares, when redeemed, may be worth more or less than original cost. Bond and bond funds will decline in value during periods of increasing interest rates.

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